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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

Before the
Federal Communications Commission
Washington, D.C. 20554

In the Matter of 1993 Annual Access Tariff Filings	)	
GSF Order Compliance Filings	)	Docket No. 93-193, Phase I, Part 2
In the Matter of 1994 Annual Access Tariff Filings	)	CC Docket No. 94-65
In the Matter of 1995 Annual Access Tariff Filings	)	
In the Matter of 1996 Annual Access Tariff Filings	)	

BELL ATLANTIC PETITION FOR CLARIFICATION

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BELL ATLANTIC[1] PETITION FOR CLARIFICATION

Summary and Introduction

In its recent order, the Commission found that Bell Atlantic and Pacific Bell incorrectly distributed their sharing obligation among the price cap baskets during the 1993-96 tariff years, and, by doing so, assigned too small a portion of the obligation to the common line basket. As a result, it directed those companies "to correct how they allocate their sharing adjustments among baskets."[2] The specific directions provided later in the order, however, address only one part of the calculation that is necessary to fully "correct" the allocation of sharing among the baskets.

1 The Bell Atlantic telephone companies ("Bell Atlantic") are Bell Atlantic-Delaware, Inc.; Bell Atlantic-Maryland, Inc.; Bell Atlantic-New Jersey, Inc.; Bell Atlantic-Pennsylvania, Inc.; Bell Atlantic-Virginia, Inc.; Bell Atlantic-Washington, D.C., Inc.; and Bell Atlantic-West Virginia, Inc.

2 Memorandum Opinion and Order at ¶ 39 (rel. Apr. 17, 1997) ("1993-96 Access Tariff Order").

Specifically, while the order outlines the procedure to reallocate sharing ***to*** the common line basket and thereby reduce the price cap indices for that basket, it does not address the corresponding procedure to reallocate sharing ***from*** other baskets and thereby increase the price cap indices for those baskets. But performing only one-half of the required calculation would not correct the previous allocation that the Commission has now concluded was incorrect, and by requiring Bell Atlantic to share more than is required by its rules would also be inconsistent with the Commission's own price cap regulations. Consequently, Bell Atlantic respectfully requests that the Commission clarify that both parts of the calculation are required in order to implement its recent order.

I. Bell Atlantic's Methodology

During the years at issue here, the Commission's rules required Bell Atlantic and other local exchange carriers ("LECs") subject to price caps to calculate a single sharing number annually based on 50 percent of the total regulated interstate earnings above 12.25 percent. Nothing in the Commission's order here questions the accuracy of Bell Atlantic's calculation of its total sharing obligation in each of the years under review, nor did any party challenge those calculations as part of their complaints here. By the same token, there is no dispute that the full amount of these sharing obligations already have been distributed to customers in the form of one-time adjustments to Bell Atlantic's price cap indices.

Rather, the sole issue in this proceeding is the method used to distribute those sharing amounts among the various price cap baskets. The Commission's price cap regulations require that a sharing adjustment be made in the same manner as exogenous changes.[3] This means that

[3] ***Policy and Rules Concerning Rates for Dominant Carriers***, 5 FCC Rcd 6786, 6801 (1990) ("Price Cap Order").

the allocation of sharing among the price cap baskets must be on a "cost-causative" basis.[4] In its order addressing the 1992 access tariffs, the Common Carrier Bureau directed that this allocation be performed using the total revenues in each of the various baskets as a proxy for cost.[5] Those carriers that had not allocated their sharing obligations based upon the revenues in each of the baskets were required to revise their filings. Significantly, the Bureau specifically recognized that the impact of its decision would be to lower rates in some baskets and to raise rates in others.[6]

Consistent with this order, Bell Atlantic's 1993 annual tariff filing did allocate its sharing obligation among baskets based upon the revenues in those baskets. In performing its calculations, however, Bell Atlantic excluded end-user Common Line revenues (subscriber line charge or "SLC") from the amount of revenue assigned to the common line basket. These revenues were excluded in order to comply with Bell Atlantic's understanding of the cost causation principles applied by the Commission. Specifically, SLC revenues are based solely on a forecasted revenue requirement, and not on price cap indices or productivity adjustments.[7] Because the SLCs are capped and the revenue requirement is set to meet the 11.25% earnings benchmark, SLCs cannot contribute to earnings above that benchmark, and so do not "cause" any earnings above the even higher threshold that give rise to sharing obligations.[8] Because the SLC

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4 47 C.F.R. § 61.45(d)(4).

5 ***1992 Annual Access Filings***, 7 FCC Rcd 4731, 4732-33 (Com. Car. Bur. 1992) ("1992 Access Order"). In that order, the Bureau rejected an allocation based on basket earnings.

6 ***Id.*** at 4734.

7 ***See*** 47 C.F.R. § 61.38.

8 ***See*** Affidavit of William E. Taylor at ¶¶ 8-11, attached as Exhibit 1 ("Taylor Affidavit").

revenues in no sense cause a sharing obligation to be incurred, it was Bell Atlantic's understanding that they should properly be excluded when allocating any sharing obligation among baskets.

II. The Complaint And Investigation

AT&T objected to Bell Atlantic's exclusion of SLC revenues in its allocation of sharing obligations among the various price cap baskets. According to AT&T, excluding these revenues "overstated the sharing amounts, and understated the access rates, for Bell Atlantic's other baskets."[9] AT&T proposed its own "corrected" allocations that increased the amount of the sharing obligation that was allocated to the Common Line Basket and decreased the amount allocated to the other baskets.[10]

In response to AT&T's complaint, the Bureau found that it was "not clear" that Bell Atlantic's exclusion of SLC revenues was consistent with prior Commission orders.[11] It concluded that there was "sufficient uncertainty to warrant investigation."[12] As a result, the Bureau suspended Bell Atlantic's rates for one day, and then allowed them to go into effect subject to an investigation and accounting order.

The investigation continued through the period in which Bell Atlantic was required to file its annual access tariffs in 1994, 1995 and 1996. Consistent with the approach taken in its 1993 filing, Bell Atlantic again excluded SLC revenues from its calculations to allocate its sharing

9 ***1993 Annual Access Tariff Filings***, AT&T Opposition to Bell Atlantic Direct Cases at 28 (filed Aug. 24, 1993).

10 ***Id.***

11 ***1993 Annual Access Tariff Filings***, CC Docket No. 93-193, Memorandum Opinion and Order, 8 FCC Rcd 4960, 4966 (Com Car. Bur. 1993).

12 ***Id.***

obligations among baskets. AT&T objected to each of these filings.[13] In each instance, AT&T recalculated the sharing amounts allocated to each basket to reflect an upward adjustment in the amount allocated to the Common Line Basket and a downward adjustment in the amount allocated to the three remaining baskets.[14]

As it had with 1993 tariff filing, the Commission responded to each of AT&T's complaints by folding the issue of how the sharing was distributed for each of the subsequent years into the existing 1993 investigation.[15]

Nowhere in the record for all four years was there ever a suggestion -- by AT&T, the Commission, or any other party -- that Bell Atlantic did not share the correct amount. Both Bell Atlantic and AT&T were clear that the issue before the Commission was a question of how the given amount of total sharing should be distributed among the baskets, not how to determine the total amount to be shared in the first instance.

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13 In 1994 and 1996, AT&T's complaint concerning the allocation of sharing was joined by one other party. In each instance, the additional party merely referenced the existing investigation concerning the allocation of sharing among baskets. Neither of these additional parties ever suggested that the resolution of their complaint would involve an increase in the total amount shared. ***1994 Annual Access Tariff Filings***, Allnet Communication Services, Inc. Petition To Suspend For One Day and Investigate (filed Apr. 26, 1994); ***1996 Annual Access Filings***, Sprint Communications Co. Petition to Reject or Alternatively Suspend and Investigate (filed Apr. 29, 1996).

14 Attached as Exhibit 2 is AT&T's calculations excerpted from each of these filings.

15 ***1994 Annual Access Filings***, Memorandum Opinion & Order, 9 FCC Rcd 3705, 3715 (1994); ***1995 Annual Access Filings***, Memorandum Opinion & Order, 11 FCC Rcd 5461, 5488-89 (1995); ***1996 Annual Access Filings***, Memorandum Opinion & Order, 11 FCC Rcd 7564, 7580 (1996).

III. The Commission's Order

In its recent order, the Commission found that Bell Atlantic and Pacific "incorrectly allocated their sharing obligations among the various service baskets."[16] The 1993-96 order does not require that Bell Atlantic recalculate its total sharing obligation (nor could it since the issue was never raised). Instead, the order requires Bell Atlantic to "correct" the manner in which it allocated its sharing obligation "among baskets."

The Commission's order is unclear in two respects. First, despite the clear requirement that Bell Atlantic must reallocate sharing "among" the baskets, and not limit its adjustment to any one basket, the more specific instructions set out at the end of the order speak only of how to "implement refunds."[17] Consequently, to remove any doubt about what was intended, the Commission should clarify that the order is intended to fix the distribution of sharing to all baskets -- not to increase the total amount shared by limiting the adjustment to the one basket that has increased sharing.

Specifically, the Commission's order directed Bell Atlantic and Pacific "to correct how they allocate their sharing adjustments among the baskets."[18] To truly "correct" the allocation of sharing, however, the indices for all of the baskets must be recalculated to reflect the allocation method in the Commission's order. In contrast, making only the downward adjustment to the indices for the Common Line basket -- and ignoring the corresponding upward adjustments to

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16 1993-96 Access Tariff Order at ¶ 39.

17 ***Id. See also Id.*** at Section V.

18 ***Id.*** at ¶ 39.

the other baskets -- would not "correct" how Bell Atlantic allocated its sharing adjustment among the baskets.

Second, the detailed instructions in Section V of the order should be clarified in a number of technical respects. First, those instructions require carriers to adjust their permanent price cap indices. But that is inconsistent with the Commission's own price cap rules, which treat sharing as a one-time event that must not have an impact beyond a single year. A reduction in the price cap index to reflect the sharing obligation for a given year is raised back up the following year, and is never embedded in the permanent price cap index.[19] Second, the instructions require carriers to recalculate their indices "at the beginning and middle of each tariff year."[20] But relying on those checkpoints would skip any tariff filings made in the interim and distort the results.[21] Finally, the Commission should correct an apparent typographical error that confuses the instructions.[22]

IV. A Partial Correction Would Be Inconsistent With the Commission's Own Price Cap Rules

Were the Commission to interpret the 1993-96 Order as requiring an adjustment only to the common line basket, Bell Atlantic would be required to increase the amount shared in that

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19 ***See*** Taylor Affidavit at ¶ 20. After consulting with Commission staff on this issue, Bell Atlantic calculated the impact of the reallocation of its sharing obligation outside of the price cap models and made a one-time adjustment to the indices to incorporate that result.

20 1993-96 Access Tariff Order, ¶ 98.

21 ***See 1993, 1994, 1995, 1996 Annual Tariff Filings***, Bell Atlantic's Revised Tariff Review Plan for Compliance with Commission's Memorandum Opinion & Order, FCC 97-139, (filed May 8, 1997).

22 ***See*** 1993-96 Access Tariff Order, ¶ 105 step 3. Instead of "ratio of revenue in 1993, the last year of this investigation, to the base year revenue," the text should read: "ratio of revenue in 1997, the last year of this investigation, to the base year revenue."

basket without the corresponding reductions in the amount shared for the other baskets. Despite the fact that the total sharing amount was never in dispute, this would have the effect of increasing the total amount of Bell Atlantic's sharing for the years in question.

Such a requirement would not only serve as a penalty on Bell Atlantic, but it would also provide a windfall to Bell Atlantic's large access customers. These customers purchase services from each of the price cap baskets. As a result, they have already benefited when Bell Atlantic shared the first time. To require Bell Atlantic to share a second time by requiring a recalculation only of the amount of sharing allocated to the Common Line Basket would allow these customers to collect twice.

While the Commission has the right to order a refund for a rate that was under timely investigation and found to be unlawful, such a refund must be consistent with the Commission's then existing rules and regulations. A refund that would "contradict the Commission's own theory" of regulation is unlawful.[23] Here, an order that increases the amount of Bell Atlantic's sharing for the years under investigation would be inconsistent with the Commission's price cap regulations in at least four respects.[24]

First, the sharing plan has a "'50-50 sharing zone' wherein LECs complying with price cap regulation will be required to share with consumers 50 percent of their earnings between

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23 ***AT&T v. FCC***, 836 F.2d 1386, 1392-93 (D.C. Cir. 1988). While the Commission has the ability to change its policy, it must "supply a reasoned analysis indicating that prior policies and standards are being deliberately changed, not casually ignored." ***Greater Boston Television Corp. v. FCC***, 444 F.2d 841, 852 (D.C. Cir. 1970), ***cert. denied*** 403 U.S. 923 (1971). Given that the Commission has recently reaffirmed the policies underlying its price cap regulation, it cannot ignore those policies here.

24 ***See also*** Taylor Affidavit at ¶¶ 13-20.

12.25 percent and . . . 16.25 percent."[25] If the redistribution were only made to the Common Line Basket, the amount that Bell Atlantic was required to share would increase to a point well above 50% of its earnings within the sharing range -- more than a 27% increase in sharing for the most recent year under review.[26]

Second, the sharing mechanism "operates only as a one-time adjustment to a single year's rates, so a LEC would not risk affecting future earnings."[27] Bell Atlantic distributed the full amount of its sharing obligation for the years in questions. Any requirement that Bell Atlantic refund additional sharing dollars without an offsetting adjustment to other baskets means that Bell Atlantic would be obliged to share a second time for past years' earnings. Its 1997 earnings would be reduced as a result, yet the Commission made no finding that the calculation of Bell Atlantic's total sharing obligation was incorrect.

Third, the sharing mechanism "is created as a backstop to the [price cap] plan as a whole, not to individual rates or even basket earnings levels."[28] "The plan stresses LEC overall productivity, and the sharing mechanism is keyed to that unified approach."[29] If the Commission, were to require a redistribution to one basket, but not to others, Bell Atlantic would have different sharing requirements for different baskets in violation of this principle.

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25 Price Cap Order at 6801.

26 Attached as Exhibit 3 is a Workpaper that calculates the percentage of earnings that Bell Atlantic would be required to share if it were required to correct the allocation of sharing only to the Common Line Basket.

27 Price Cap Order at 6803.

28 ***Policy and Rules Concerning Rates for Dominant Carriers***, Order on Reconsideration, 6 FCC Rcd. 2637, 2679 (1991) ("Price Cap Reconsideration Order").

29 ***Id.***

Finally, changes in the price cap levels are to be based on exogenous costs changes, inflation or expected productivity growth.[30] Indeed, the Commission has recently announced a large increase in the price cap productivity factor, and even required all current indices to be adjusted to reflect revised productivity calculations for last year.[31] This change will have the impact of significantly reducing access rates. It would be inconsistent with price cap regulation in general, and the Commission's price cap reform decision in particular, to now require a significant ***additional*** reduction based on prior years' sharing obligations when all parties must concede that the correct sharing amount was distributed in full in a timely fashion.[32]

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30 ***See*** 47 C.F.R. § 61.45.

31 ***FCC News Release*** "Commission Reforms Its Price Cap Plan," Report No. CC 97-22 (rel. May 7, 1997).

32 ***See*** Taylor Affidavit at ¶¶ 14-15.

Conclusion

For all the foregoing reasons, Bell Atlantic respectfully requests that the Commission clarify that Bell Atlantic should correct the allocation of its sharing obligations by making a temporary adjustment to the indices in each of its baskets to reflect the requirements of the Commission's recent order governing the allocation of sharing.

Respectfully submitted,

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May 19, 1997

EXHIBIT 1

BEFORE THE

FEDERAL COMMUNICATIONS COMMISSION

WASHINGTON, D.C. 20554

In the Matter of	)	**CC Docket No. 93-193**
1993 Annual Access Tariff Filings	)	**Phase 1, Part 2**
	)	
GSF Order Compliance Filings	)	
	)	
In the Matter of	)	
1994 Annual Access Tariff Filings	)	**CC Docket No. 94-65**
	)	
In the Matter of	)	
1995 Annual Access Tariff Filings	)	
	)	
In the Matter of	)	
1996 Annual Access Tariff Filings	)	

AFFIDAVIT OF WILLIAM E. TAYLOR

1. I am Senior Vice President of National Economic Research Associates, Inc. (NERA), head of its telecommunications economics practice and head of its Cambridge office. My business address is One Main Street, Cambridge, Massachusetts 02142.

2. I have been an economist for over twenty-five years. I received a B.A. degree in economics (Magna Cum Laude) from Harvard College in 1968, a master's degree in statistics from the University of California at Berkeley in 1970, and a Ph.D. in Economics from Berkeley in 1974, specializing in industrial organization and econometrics. I have taught and published research in the areas of microeconomics, theoretical and applied econometrics, and telecommunications policy at academic institutions (including the economics departments of Cornell University, the Catholic University of Louvain in Belgium, and the Massachusetts

Institute of Technology) and at research organizations in the telecommunications industry (including Bell Laboratories and Bell Communications Research, Inc.). I have participated in telecommunications regulatory proceedings before state public service commissions and the Federal Communications Commission ("FCC") concerning competition, incentive regulation, price cap regulation, productivity, access charges, pricing for economic efficiency, and cost allocation methods for joint supply of video, voice and data services on broadband networks. A copy of my vita was provided as an attachment to my affidavit filed on behalf of Bell Atlantic and other parties in CC Docket No. 96-46 on April 26, 1996.

I. BACKGROUND AND SUMMARY

3. In its Memorandum Opinion and Order in CC Docket Nos. 93-193 and 94-65,[1] the FCC resolved most of its open investigations of price cap issues arising in the four annual access filings that have occurred since 1993. Among other things, the *1993-96 Access Tariff Order* found that Bell Atlantic allocated its earnings sharing adjustment to its price cap baskets incorrectly. The price cap rules specify that the customer share (including interest) is to be refunded through a one-time reduction in the PCI for the next rate period, calculated in the same manner as other exogenous changes.[2] Section 61.45(d)(4) of the Commission's Rules specifies that exogenous changes should be allocated among the four price cap baskets on a "cost-causative" basis. The *1993-96 Access Tariff Order* found that Bell Atlantic's allocation—based on revenue from carrier access services (omitting subscriber line revenue)—was incorrect in its annual filings for 1993 through 1996. As a result, the *1993-96 Access Tariff Order* directs Bell Atlantic to correct its allocation, revise its indices and implement refunds so that its pricing limits

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[1]In the Matter of 1993 Annual Access Tariff Filings, GSF Order Compliance Filings, 1994 Annual Access Tariff Filings, 1995 Annual Access Tariff Filings, 1996 Annual Access Tariff Filings, *Memorandum Opinion and Order*, CC Docket Nos. 93-193 (Phase 1, Part 2) and 94-65, released April 17, 1997 (the "1993-96 Access Tariff Order").

[2] Policy and Rules Concerning Rates for Dominant Carriers, *Second Report and Order* 5 FCC Rcd at 6801 (1990) ("LEC Price Cap Order").

reflect the corrected allocation and overcharges relative to those limits are refunded to customers.[3] The specific adjustments outlined in the Order, however, do not accomplish these goals.

4. From an economic perspective, Bell Atlantic's method of allocating its sharing adjustment among baskets in its 1993 to 1996 tariffs was reasonable and returned the proper sharing amount—half its earnings between 12.25 and 16.25 percent—to its interstate customers. In addition, Bell Atlantic's allocation method appears to have been consistent with the Commission's *1992 Annual Access Order* because it allocated adjustments to price limits proportionally across services on a cost causative basis, rather than targeting reductions to services according to productivity growth or other criteria. The Commission has concluded, however, that Bell Atlantic's allocation method was wrong and should be corrected. The purpose of this affidavit is not to second guess that conclusion. Rather, this affidavit explains from an economic standpoint, the proper way to correct the sharing allocation to comply with the Commission's order in order to ensure that the correct amount is shared with interstate customers and the efficiency incentives established in the price cap plan are preserved.

5. As I explain below, implementing the *1993-96 Access Tariff Order* should entail no aggregate refund obligation for Bell Atlantic because interstate customers, in total, already received precisely the earnings sharing adjustment to which they were entitled. The *1993-96 Access Tariff Order*, however, sets out a method for calculating a refund liability for baskets that received too little sharing adjustment; but does not specify how to calculate the offsetting effect for the baskets that received too much. If the order were interpreted—incorrectly from an economic perspective—to mean that Bell Atlantic should incur a liability for its incorrect under-allocation of the earnings sharing adjustment to the common line basket but not offset that liability with the incorrect over-allocation of the earnings sharing adjustment to the three other price cap baskets, such an interpretation would be inconsistent with the Commission's price cap

[3] *1993-96 Access Tariff Order*, ¶ 39. Two adjustments are required to Bell Atlantic's PCIs, SBIs and maximum CCL rate: (i) a permanent adjustment to correct its PCIs (and other pricing limits) "so that those PCIs are what would have been in place had they been calculated consistent with the Commission's rules and decisions" [*1993-96 Access Tariff Order* at ¶ 97] and (ii) a one-time adjustment to "refund to [its] customers all amounts, plus interest, collected as a result of overcharges." [*1993-96 Access Tariff Order* at ¶ 104].

rules since it would require Bell Atlantic to share more in total than is required, and would represent bad economic policy. The economic consequence would be bad for customers because changes in the price cap rules after the fact would undercut the incentives the regulated firm has under price caps to lower costs, expand demand and (generally) to increase productivity growth. It would also mean that some customers would receive an unwarranted windfall since the correct amount has already been shared with customers.

II. BELL ATLANTIC'S PREVIOUS ALLOCATION WAS CONSISTENT WITH THE ECONOMIC PRINCIPLES UNDERLYING THE COMMISSION'S *1992 ACCESS TARIFF ORDER* AND RETURNED THE CORRECT SHARING AMOUNT TO CUSTOMERS.

6. In 1990, the FCC adopted a price cap plan for the regulation of the interstate services of local exchange carriers. The plan identified four baskets of services (common line, traffic sensitive, special access and interexchange) and adjusted four price cap indices independently (one for each basket) using a formula that combined national inflation, a single productivity offset (**X**) and adjustments for exogenous changes in costs.[4] By replacing traditional rate of return regulation with price cap regulation, the Commission sought to correct the incentives under which regulated local exchange carriers operated, essentially breaking the link between accounting costs and service prices. At the same time, the Commission instituted an earnings sharing and backstop mechanism to mitigate the efficiency losses from possible differences in prices and costs and to introduce a self-correcting mechanism into the plan.

7. The earnings sharing and backstop mechanism was triggered by earnings for the aggregate of all interstate services in all four price cap baskets. Over-earnings were returned by a one-time (one year) reduction in the PCI for each basket, where the sharing amount was to be allocated to each basket on a "cost-causative" basis, in the same manner as other exogenous cost changes were allocated to baskets. For general exogenous cost changes, the economic intent of this requirement was to tie as tightly as possible exogenous changes in costs for a service to

[4] The plan also identified service categories and subcategories within baskets whose price changes were limited by upper and lower price bands around a subindex of prices called the Service Band Index ("SBI") which moved with the PCI change for each basket.

changes in price for that service, so that, for each service, prices and exogenous costs would move together. Similarly, for the special case of sharing, assignment of the total amount to each basket on a cost-causative basis is also desirable because it tends to move service prices in each basket as costs change in that basket.

8. In its *1992 Access Tariff Order*, the Commission determined that revenues in each basket could be used as a proxy for costs in each basket: "because rates are set based on costs, revenue should equal costs." From this reasonable approximation, the Order concluded that, because revenues in each basket approximately equal costs in each basket, allocating exogenous cost adjustments to the baskets by revenue was, in effect, an allocation on a cost-causal basis.[5] Because price limits for the different baskets will generally move in proportion to the change in costs, such an allocation broadly comports with the economist's notion of a cost-causal allocation.

9. While this method is generally correct, the common line basket requires special treatment under the assumptions of the *1992 Annual Access Order* in order that a revenue-based allocation achieve a cost-causative result. The issue here is different from that addressed in the *1992 Annual Access Order*. In that Order, the Commission declined to allow price cap LECs to target sharing allocations to baskets depending on the degree to which services in the basket contributed more or less to the productivity growth that led to the earnings sharing adjustment. The Commission determined that productivity growth in all interstate services is responsible for an aggregate earnings sharing requirement and therefore that all interstate services should benefit proportionately from the sharing adjustment.[6] Given, then, that the objective of the allocation method is to reduce price ceilings for all interstate services in the same proportion, the common line basket requires special treatment if sharing amounts are to be allocated correctly from an economic standpoint.

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[5] *1992 Annual Access Order*, 7 FCC Rcd at 4733. As the Common Carrier Bureau noted, "allocating sharing and low end adjustments on the basis of relative basket revenues most closely comports with the goals of the Commission's price cap plan" and that such an allocation is consistent with the requirement that the sharing obligation be calculated on the basis of total interstate earnings: *1992 Annual Access Order* 7 FCC Rcd at 4732-33.

[6] *Ibid.*

10. The problem is that the common line basket recovers costs associated with a single network element (the loop) but historically has contained rates for two different services. End users have paid subscriber line charges ("SLCs") on a monthly basis for each of their lines, while interexchange carriers have paid the carrier common line ("CCL") charge for every minute of interstate switched access. A second problem is that the SLCs are separately capped under the price cap plan and cannot move as the PCI for the common line basket moves. Thus, changes in the common line PCI do not impact common line services equally; rather, they impact only the CCL and the price interexchange carriers pay for switched access service. Given the constraint on the SLCs, the object of any allocation of sharing adjustments to the baskets should be to approximate as closely as possible, the prices (or price limits) for services that would pertain if there were no restrictions on the SLCs. Since, by assumption, the sharing adjustment reflects a reduction in costs of all services by the same proportion, we would like to see equal proportional reductions in prices (or price limits) for all services. Such an allocation would minimize the distortion caused by the constraint that SLCs neither rise nor fall in response to changes in costs.[7] In contrast, the effect of allocating a sharing adjustment on the basis of total common line revenue would be to weight disproportionately the remaining services in the common line basket, namely the CCL charge.

11. Consider a 10 percent exogenous cost change—like a sharing adjustment—that reflects a proportional reduction in all costs and should therefore reduce all price limits proportionally. Suppose, for simplicity, the revenue share of each basket was 25% and half the common line basket corresponded to SLC revenue and half to CCL revenue. If the reduction were allocated across the price cap baskets using all revenues (including SLC revenue), PCIs would fall by 10 percent in each basket. However, prices would not change in those proportions because in the common line basket, the CCL would fall by 20 percent and SLCs would remain

[7] This is the economic reason that deviating from an allocation based on total common line basket revenue is the correct approach. It is *not* an attempt to allocate the sharing adjustment disproportionately to baskets following some notion of disproportionate responsibility for productivity growth (which was rejected in the *1992 Annual Access Tariff Order)*. Rather, it is a necessary adjustment in the allocator to achieve what was ordered in the *1992 Annual Access Tariff Order*: an equiproportional flow-through of the earnings adjustment to all interstate services.

constant. This reduction would distort the relationship among prices and costs across the price cap baskets: for example, switched access prices would fall by more than 10 percent while special access prices would fall by exactly 10 percent. Under these assumptions, assigning the exogenous cost change to baskets by revenue is not cost-causative and potentially distorts interexchange carriers' choices of access services. In contrast, if SLC revenues are ignored in the allocation, the CCL and the PCIs for the remaining (non common line) baskets fall by the same amount (11.4 percent of revenues less SLC) so that the requirement that SLCs remain unchanged does not distort the proportional price reductions among services in different baskets, such as switched and special access.

12. As the above discussion demonstrates, the method employed by Bell Atlantic to allocate sharing was reasonable from an economic standpoint, was consistent with the previous Commission determination that an earnings sharing adjustment should be spread proportionally across all services, and was also consistent with the objectives of the Commission's price cap rules. Given that Bell Atlantic's method of assigning the sharing adjustment on a cost-causative basis has been determined to be incorrect, the question has become one of how its PCIs, SBIs and CCL should change to correct the errors in the 1993-1996 filings and how refunds of overcharges—if any—should be calculated and implemented.

III. ONE-TIME CHANGES TO REFUND OVERCHARGES ARE UNWARRANTED.

13. Subsection C of the *1993-96 Access Tariff Order* sets out only part of the required calculations to correctly determine the amount of any "refund to ... customers all amounts, plus interest, collected as a result of overcharges."[8] Basically, the portion of the calculation included in the order would classify a customer as "overcharged" if, at half-year periods from 1993 through 1996, any API exceeds its corresponding PCI, any SBI exceeds its upper limit or any CCL rate in effect exceeds the maximum CCL rate. The order does not, however expressly set out the rest of

[8] *1993-96 Access Tariff Order* at ¶ 104.

the calculation required to correctly determine the amount of any overcharge to be refunded through a 1997 one-year exogenous cost change.

14. To fully adjust for the change in allocation method, the Commission must include an equivalent adjustment to reflect the amount of sharing over-allocated to the remaining three baskets. Each basket, calculated independently, should have a one-time adjustment to its PCI, to reflect such a change.[9] While the customers for services in those baskets also pay CCL charges, they benefited from the additional sharing that was allocated to them by virtue of the exclusion of end-user revenues in Bell Atlantic's original allocation to the CCL Basket. If the Commission has determined that Bell Atlantic should be required to correct for the impacts of such exclusion, all such impacts must be addressed. To do otherwise, as explained below, would be to distort the final sharing amounts so that they would not be consistent with the Commission's revised allocation method, or with the price cap rules in general.

A. Performing only a partial calculation would distort the incentives in the price cap plan.

15. In contrast to the correct method for reconstructing Bell Atlantic's indices, performing only the portion of the calculations set out in the order would effectively require Bell Atlantic to share a larger portion of its earnings in each of the years 1993 through 1996 than the amount called for in the price cap plan. It is generally recognized that the sharing of earnings has deleterious effects on the incentives for regulated firms to reduce costs and expand output.[10] To the extent that the refund calculation were performed in a way that increases the sharing obligation of the regulated firm, it reduces the firm's incentives to undertake activities that increase earnings. In addition, the fact that the refund calculation treats interstate services asymmetrically—reducing switched access price limits more than proportionately and special access and interexchange price limits less than proportionately—further distorts incentives from

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[9] The result may be to create additional distance between the PCI and the API for those baskets. Consistent with the price cap rules, a carrier is free to adjust its prices up or down, so long as they do not exceed the PCI.

[10] Indeed, earnings sharing has been eliminated in the price cap plan changes announced by the FCC on May 7.

those that an unregulated firm would face in competitive markets where proportionate reductions in costs across services would—all else equal—result in proportionate reductions in service prices. Similarly, the asymmetric treatment of errors that resulted in a cap higher than otherwise allowed, and those that lead to a cap lower than otherwise allowed would change the risk that the regulated firm faces when it is required to calculate parameters of the price cap plan for long periods of time with no explicit directions beyond general principles.

16. In addition, the fact that the price cap plan parameters are subject to regulatory change—as long as four years after the fact—increases the regulatory risk in a price cap plan that was intended to reduce regulatory uncertainty. In unregulated, competitive markets, firms believe that actions they take to increase productivity growth will result in higher profits, and accordingly they risk their capital and effort in the expectation that they will be rewarded if they are successful in the market. In theory, price-cap regulated firms face similar incentives because increased productivity growth leads to higher earnings, provided only that the higher earnings are not achieved by increasing prices above the amount allowed by the various price cap indices. If the rules of the price cap plan change in mid-stream, firms will no longer treat the parameters of the plan as fixed and attempt to maximize profits. As observed in the economic literature on incentive regulation

> (i)f large financial rewards and penalties are linked to performance measures over which the [regulated] firm has relatively little control. the firm will be exposed to substantial risk, and corresponding gains from improved incentives will be minimal.[11]

Ultimately, it is the belief of the regulated firm that the deck is not stacked and that increased productivity will lead to increased profits that generates the improved performance associated with price cap regulation. Regulatory decisions that undermine those beliefs threaten the benefits that customers expected to receive from adoption of price cap regulation.

[11] D. Sappington and D. Weisman, *Designing Incentive Regulation for the Telecommunications Industry*, Cambridge: MIT Press, 1996, p. 334.

B. Performing only a partial calculation would not compensate customers for overcharges.

17. According to the *1993-96 Access Tariff Order*, the refund liability "must compensate customers for overcharges incurred during the course of this investigation." (at ¶104). Thus, if no customer paid more than if Bell Atlantic had allocated its sharing obligation in accordance with the *1993-96 Access Tariff Order*, then no customer suffered damages and there is no refund liability. This standard is consistent with the incentive structure of the FCC's price cap plan, where the firm is left free to set prices wherever it can, provided that various price ceilings (the PCI, SBIs, and the maximum CCL) are respected. Only when the actual API exceeds the PCI recalculated in accordance with the *1993-96 Access Tariff Order*—or when an actual SBI or CCL rate exceeds the recalculated maximum SBI or CCL rate—would a customer have paid more than it would have if Bell Atlantic allocated its earnings sharing adjustment according to the new Order. Hence, the refund obligation should compare what customers were charged relative to the maximum that they would have been charged had Bell Atlantic calculated its sharing adjustment as required in the *1993-96 Access Tariff Order*.

18. The result of that calculation can be positive or negative in any basket, and, in aggregate, customers of interstate services were not overcharged at all. The correct amount of earnings sharing adjustment was calculated and returned to customers through reductions in the PCIs, SBIs and CCL rates over all four baskets in every year. If the allocation had been done in accordance with the *1993-96 Access Tariff Order*, the allocation across baskets would have been different in each year, but the total amount returned to customers would have remained the same as was actually returned to customers in each year.

C. The proposed method of calculation is incomplete and incorrect.

19. Performing only the partial calculation set out in the *1993-96 Access Tariff Order* would not calculate the amount by which customers were overcharged, including interest. First, even focusing only on the Common Line Basket, there appears to be double-counting in the overcharge calculation which simply sums the overcharges associated with the PCIs, SBIs and the maximum CCL rate as if these price limits were independent. Suppose one rate element—for

example, the CCL—were incorrectly priced too high so that, in addition, both the API and an SBI exceeded its corresponding PCI and SBI upper bound. The amount by which a customer was overcharged is the excess revenue from the overpriced CCL rate element, not the sum of the revenues associated with the excess API, SBI and maximum CCL rate.

20. Second, performing only the partial calculation—that is if the offsetting undercharges were ignored—would force Bell Atlantic to share more than the amount required in the price cap plan. This not only would be inconsistent with the Commission's own rules, but it would be unwise economic policy since it would undermine the very incentives price caps were designed to create.

21. Third, if total common line revenue were used to allocate the earnings sharing adjustment, switched access price limits would fall by a greater percentage than special access or interexchange price limits, despite the assumption in the *1992 Access Tariff Order* that earnings derive from all interstate services and thus that all interstate service costs have fallen proportionately, and price limits should follow proportionately.

IV. PERMANENT CHANGES TO CORRECT PRICE LIMITS ARE UNNECESSARY.

22. Unlike some of the other investigation issues resolved in the *1993-96 Access Tariff Order*, a misallocation of the earnings sharing adjustment has no permanent effect on price limits. Since each exogenous adjustment to implement sharing is effectively removed at the next annual filing, any error in Bell Atlantic's PCIs (and other pricing limits) lasts only one year.[12] Thus if it were determined that Bell Atlantic's allocation of sharing adjustments were incorrect in every year, no change would be required to the calculations of Bell Atlantic's PCIs, SBIs and maximum CCLs to become effective June 30, 1997. The (incorrect) adjustments made in June 1996 must be reversed—as they would be absent the *1993-96 Access Tariff Order*—and the new exogenous adjustment for sharing (if any) must be allocated across the price cap baskets in accordance with

[12] Thus any error in the 1993 filing affects the July 1993 and January 1994 PCIs but not the July 1994 (and future) PCIs. Similarly, errors in the 1994 filing have no effect on the PCIs on or after July 1995, etc.